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AN AUDIT VERSUS A FRAUD EXAMINATION

By Annette Stalker, CPA/CFF, CFE, and Michael G. Ueltzen, CPA/CFF, CFE

The terms GAAS audit, forensic accounting, *and* fraud examination *are frequently used, sometimes interchangeably, by the general public and practitioners in day-to-day conversations. However, these terms are the names of distinct services that have important differences.*

This article discusses some of the basic and fundamental differences in the approach, scope, procedures, and costs related to each of the above services.

HISTORY AND GUIDING PRINCIPLES

GAAS Audit

An audit is conducted in accordance with generally accepted auditing standards (GAAS) established by the AICPA's Auditing Standards Board (ASB) in the form of Statements on Auditing Standards (SASs). Entities defined as *issuers*[1] are required to have audits conducted in accordance with auditing standards governed by the Public Company Accounting Oversight Board (PCAOB).[2] For the balance of this article, audits under both the AICPA and PCAOB standards will be referred to as *GAAS audits.*

The AICPA standards cover auditor qualifications, conduct of field work, and reporting results. The first auditing procedure standard was issued in October 1939. The first SAS was issued in November 1972 and, as of December 2008, the ASB has issued 115 statements.

An audit performed in accordance with GAAS considers fraud risks throughout the process because it is designed to obtain reasonable assurance as to whether the financial statements are free of material misstatement, whether caused by fraud or error. The financial statements and related internal controls over financial reporting are a basic responsibility of company management.

Forensic Accounting

Forensic accounting can be traced back to the 1800s when James McClelland of Glasgow, Scotland began a business that, in part, advertised "the making up of statements, reports on disputed accounts and claims for the purpose of laying before arbiters, courts, or counsel."[3]

1 An issuer is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

2 Initially the PCAOB adopted the AICPA's auditing standards (Statement on Auditing Standards Nos. 1–101) on an interim basis; as of December, 2008, six PCAOB Auditing Standards exist.

3 Alex Moore, "The Accountant as an Expert Witness," *The Accountant*, June 29, 1907, pp. 879–886.

A fraud examination is a subset of forensic accounting.

With the development of the Certified in Financial Forensics (CFF) credential, the AICPA has adopted the definition of *forensic accounting* as "generally involving the application of specialized knowledge and investigative skills possessed by CPAs to collect, analyze, and evaluate evidential matter and to interpret and communicate findings in the courtroom, boardroom, or other legal or administrative venues."

Forensic accounting services can be segmented into seven core areas: (1) economic damages, (2) valuations, (3) fraud prevention and detection and fraud examinations, (4) bankruptcy, insolvency, and reorganizations, (5) financial statement fraud, (6) family law matters, and (7) computer forensics. A fraud examination is only one part of the broad umbrella of forensic accounting services.

Fraud Examination

The Association of Certified Fraud Examiners (ACFE) defines a *fraud examination* as "a methodology for resolving fraud allegations from inception to disposition. More specifically, fraud examination involves obtaining evidence and taking statements, writing reports, testifying to findings, and assisting in the detection and prevention of fraud."[4]

Each fraud examination is unique in that the approach and exam steps are determined first by the predication. The approach is then changed as evidence is uncovered. Predication is the totality of circumstances that would lead a reasonable, professionally trained, and prudent individual to believe a fraud has occurred or may occur.[5] Several elements of a fraud examination are not typically part of a GAAS audit. Some of these elements may include the practitioner's background in criminology, education in behavioral sciences, knowledge of rules of evidence, training in public records searches, experience with electronic data mining, and his or her application of this knowledge and experience.

IS ANYTHING THE SAME?

Although general public opinion seems to be that a GAAS audit is closely related to a fraud examination, that perception is incorrect, and its incorrectness is confirmed by a review of the authoritative guidance. Aside from the gathering and analysis of financial information, a GAAS audit and a fraud examination do not share many similarities. Rather than detail every difference between a GAAS audit and fraud examination, we illustrate in the chart below the basic contrast of some fundamental distinctions:[6]

GAAS Audit v. Fraud Examination
An Illustration of the Key Distinctions of Each

WHAT	= FREQUENCY	+ KEY ELEMENTS	+ RESULT
GAAS AUDIT	Recurring	• Tailored Audit Programs • Materiality • Evaluate Internal Controls • Audit Tests & Evidence • Costs Estimable	Opinion on Financial Statements
FRAUD EXAMINATION	Non-Recurring based on Predication	• No Roadmap • Custom Procedures • Hypothesis and Test • Interviews • Chain of Evidence • Costs Difficult to Estimate	Possible Report to Board, Management or Authorities

DETAILS OF GAAS AUDITS AND FRAUD EXAMINATIONS

GAAS Audits

"The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles."[7]

4 The Association of Fraud Examiners, *2008 Fraud Examiners Manual.*

5 Ibid.

6 For example, an audit includes an evaluation of internal controls, an understanding of the accounting systems within the entity, completion of risk assessments (including fraud risk, control risk, and detection risk), tailored audit programs, and audit tests designed to result in sufficient appropriate audit evidence.

7 Paragraph .01 of AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1).

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In addition to the concept that a GAAS audit enables an independent accountant to express an opinion as to the fairness of the financial statements, several additional precepts are embedded in the general approach of a GAAS audit.

1. APPROACH

Concept of materiality and reasonable assurance

The GAAS standards recognize that a GAAS audit should be planned and performed to obtain reasonable assurance about whether the financial statements are free from material misstatement whether caused by error or fraud.[8] Another element of reasonable assurance includes the concept of selective testing of the data to be audited and the use of judgment regarding both the areas to be tested and the nature, timing, and extent of the test to be performed. Finally, judgment is required in interpreting the results of the audit testing and evaluating audit evidence.

2. SCOPE

Responsibility of Management

Company management is responsible for the financial statements. Management has the responsibility to adopt sound accounting policies and to establish and maintain internal control that will, among other things, initiate, authorize, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements.[9] At the outset of the engagement, the auditor establishes an understanding with the client regarding the services to be performed. This understanding is documented in the engagement letter. As part of the audit, the auditor obtains a management representation letter. Management's responsibility is specifically referenced in the independent accountant's report.[10]

Use of Professional Skepticism

Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the audit evidence.[11] Professional skepticism should be exercised throughout the audit process. When exercising professional skepticism, the auditor neither assumes that management is dishonest nor assumes unquestionable honesty.[12]

3. PROCEDURES

Sufficiency of Audit Evidence

The auditor relies on evidence that is persuasive rather than convincing. The types of audit procedures the auditor performs are as follows:

- Inspection
- Observation
- Inquiry
- Confirmation
- Recalculation
- Re-performance
- Analytical procedure

Consideration of Fraud Characteristics

The audit standards recognize that because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement. The characteristics of fraud that may preclude a properly planned and performed GAAS audit from detecting the fraud include the following:

- Concealment through collusion among management, employees, or third parties
- Withheld, misrepresented, or falsified documentation
- The ability of management to override or instruct others to override what otherwise appear to be effective controls[13]

Assessment of the Fraud Risk

During the conduct of a GAAS audit, the auditor should

- discuss among engagement personnel the risks of material misstatement due to fraud;
- make inquiries of management and others within the entity about the risk for fraud;
- consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit;
- consider whether one or more fraud risk factors exist;
- consider other information that may be helpful in identifying risks of material misstatement due to fraud;[14]
- use the information gathered to identify risk of material misstatement due to fraud;
- presume that improper revenue recognition is a fraud risk;
- consider the risk of management override of controls; and
- respond to the results of the risk assessment.

Imbedded in a GAAS audit are the concepts of dual responsibilities (management and the auditor), reasonable assurance, professional skepticism, sampling, assessing the risk of fraud, and use of professional judgment in evaluating the results of the audit work undertaken. As acknowledged in the professional literature, *an audit conducted in conformity with GAAS may not detect a fraud due to the concealment through collusion, withheld, misrepresented or falsified documentation, and the ability to override what otherwise appear to be effective internal controls.*

8 AU section 110 paragraph .02.
9 AU section 110 paragraph .03.
10 AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1).
11 Paragraph .07 of AU section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1).
12 AU section 230 paragraph .09.
13 AU section 230 paragraph .12.
14 Paragraph .19 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1).

4. TIME AND COSTS

The auditor is typically able to estimate the time and costs that would be necessary to complete an audit for an entity based on several factors: history and experience with the client; review of audit requirements and industry guides; company organization and regulation; and the company control environment and its associated risks. In addition the auditor and the client are often subject to regulatory or contractual deadlines to deliver the audited financial statements.

Fraud Examination

The conceptual approach, scope, procedures, and time and costs associated with a fraud examination are fundamentally different from the approach undertaken in a GAAS audit. From the initial predication to the planning and execution of the examination, the fraud examiner evaluates the hypothesis about a hidden fraud.

1. APPROACH

The traditional audit methodology is fundamentally redefined in the conduct of the fraud examination as discussed by Ronald L. Durkin, CPA/CFF, CFE, Senior Managing Director of Durkin Forensic, Inc. In an article, "Defining the Practice of Forensic Accounting," *CPA Expert* (Special Issue 1999), Durkin includes the following concepts:

- Not limiting the scope of the engagement based upon materiality
- Not accepting sampling as evidence
- Not assuming management has integrity[15]
- Seeking the best legal evidence
- Melding the requirements of the evidential matter standard with the rules of evidence

The forensic accountant performing a fraud examination is involved after the fact. The process begins in response to a complaint or suspicion of fraud related to financial and accounting issues. In addition the fraud examiner may work directly with counsel, who will assist in the development of the scope and conduct of a fraud examination

2. SCOPE

The Association of Certified Fraud Examiners has also identified the principal differences between the auditing and fraud examination,[16] as outlined in the following table:

Issue	Auditing	Fraud Examination
Timing	Recurring Audits are conducted on a regular, recurring basis.	Nonrecurring Fraud examinations are nonrecurring. They are conducted only with sufficient predication.
Scope	General The scope of the audit is a general examination of the financial data.	Specific The fraud examination is conducted to resolve specific allegations.
Objective	Opinion An audit is generally conducted for the purpose of expressing an opinion on the financial statements or related information.	Affix Blame The fraud examination's goal is to determine whether fraud has occurred or is occurring and to determine who is responsible.
Relationship	Nonadversarial The audit process is nonadversarial in nature.	Adversarial Fraud examinations, because they involve efforts to affix blame, are adversarial in nature.
Methodology	Audit Techniques Audits are conducted primarily by examining financial data.	Fraud Examination Techniques Fraud examinations are conducted by (1) document examination; (2) review of outside data such as public records; and (3) interviews.
Presumption	Professional Skepticism Auditors are required to approach audits with professional skepticism.	Proof Fraud examiners approach the resolution of a fraud by attempting to establish sufficient proof to support or refute an allegation of fraud.

3. PROCEDURES

The use of forensic procedures will often reveal evidence that is different from that obtained through the audit procedures outlined in the AICPA *Professional Standards.* As noted in the preceding table, several non-GAAS procedures are used in the course of a fraud investigation. They include the following:

a. Extensive use of *interviews*, leveraging techniques designed to elicit sufficient information to prove or disprove an hypothesis
b. Document *inspection* that may extend to authentication procedures and handwriting analysis
c. Significant *public records* search to uncover, for example, unexpected title or ownership, other known addresses, and prior records of individuals
d. Legal knowledge regarding *rules of evidence* including chain of custody and preservation of evidence integrity

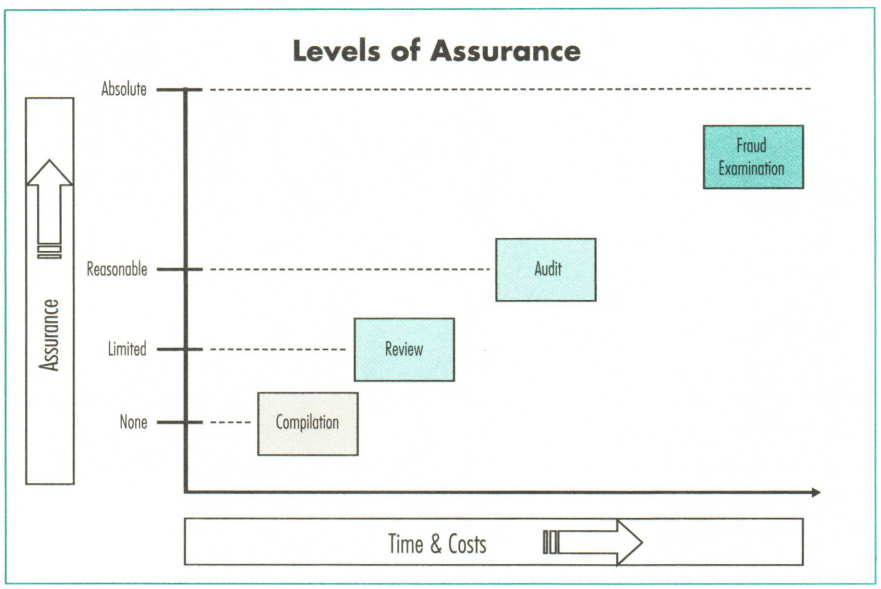
In considering the procedures employed by the fraud examiner, it is important to understand the contrast between the level of assurance provided by and the time and costs associated with a GAAS audit and those of a typical fraud examination.

4. TIME AND COSTS

Because of the hidden nature and unpredictable extent of possible fraud, the time required for and the costs of fraud examinations are difficult to estimate at the outset. Because fraud examinations are not recurring, nor does any one investigation

15 In a GAAS audit (AU section 230 paragraph .09), the auditor neither assumes that management is dishonest nor assumes unquestioned honesty; the mindset of a person conducting a fraud examination does not assume management has integrity.

16 Association of Certified Fraud Examiners, *2008 Fraud Examiners Manual.*



mirror another, no reliable historical record is available to estimate costs to complete a project. Frequently the time and costs of a fraud examination are significantly greater than those of an audit; in many cases the costs may be a multiple of ten times greater or more for a fraud examination than a GAAS audit.

CONCLUSION

The purpose, approach, scope, and procedures for a GAAS audit and a fraud examination differ dramatically from one another. The scope, procedures, approach, and time and costs are fundamentally different between a GAAS audit and a fraud examination. Accordingly and as should be expected, the level of assurance provided by the accountant is designed to be different. The bottom line is that a GAAS audit and a fraud examination are different services specifically designed for different purposes.

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EMPIRICAL DATA SOURCES FOR THE RELIEF FROM ROYALTY METHOD

By Ashley L. Reilly and Robert F. Reilly, CPA/ABV

Valuation analysts are often asked to value intellectual property: patents, trademarks, copyrights, and trade secrets. These valuations may be performed for the following purposes: financial accounting and fair value reporting; sale and license transaction structuring and fairness opinions; asset-based collateral and sale/license back financing transactions; formations of joint ventures and intellectual property holding companies; income tax compliance related to charitable contributions and other tax deductions; intercompany and third party transfer pricing; and lost profits/economic damages analysis related to infringement and other litigation claims.

Valuation analysts often use the relief from royalty method (the RFR method) to estimate intellectual property value. They may also use this method to value other types of commercial intangible assets, as long as sufficient transactional data are available from which to extract a market-derived royalty rate. Valuation analysts often find that a paucity of empirical data exists with regard to the arm's length license of most commercial intangible assets. Because of this data constraint the RFR valuation method is used primarily to value patents, trademarks, copyrights, and trade secrets.

Depending on the source of the intellectual property royalty rate used in the valuation analysis, the RFR method may be considered either a market approach method or an income approach method. If the source of the intellectual property royalty rate is a fair return on the intellectual property value, then the RFR method may be considered a cost approach method. However, this valuation approach categorization process is really a matter of semantics. Whether the source of the selected intellectual property royalty rate is a "comparable uncontrolled transaction" license (market approach), a profit split analysis (income approach), or a fair return on an intangible asset value (cost approach)

- the theoretical foundation of the RFR method remains the same.
- the practical application of the RFR method remains the same.
- the value conclusion of the RFR method remains the same.

This article provides a summary description of the common sources of empirical transactional data with regard to intellectual property licenses. In the application of the RFR method, the valuation analyst typically considers the following sources of data related to the intellectual property royalty rate:

- Print data sources
- Online data sources
- "Other" data sources

THE RFR METHOD

First, the RFR method is based on the fact that intellectual property

total ownership rights are often disaggregated between licensors and licensees. In addition, the intellectual property ownership total rights are often disaggregated between an owner (the intellectual property developer) and an operator (the entity that uses the subject intellectual property).

Second, the RFR method assumes that if the current owner is the intellectual property operator (but not the intellectual property developer), then the actual owner should be willing to license the subject intellectual property from the hypothetical owner/licensor. In the hypothetical license agreement, the actual owner is the intellectual property licensee. And the hypothetical owner is the intellectual property licensor. In the hypothetical license agreement, the actual owner (as the party using the subject intellectual property) will have to pay a market-derived royalty for the use of the subject intellectual property.

Third, intellectual property license agreement royalties are usually based on a royalty rate. License agreement royalty rates are usually calculated as either

- X% of operator revenue (or some other operator income measure),
- $Y per operator unit produced (or per operator unit sold), or
- $Z per time period (for example, per year).

Fourth, because the current owner owns the subject intellectual property, the owner does not have to pay a licensor to license the use of the subject intellectual property. Therefore the current owner is "relieved" from having to pay a royalty for the use of the intellectual property to an intellectual property licensor.

The RFR method basic valuation formula is as follows:

$$\text{intellectual property value} = \frac{\text{owner/operator revenue} \times \text{royalty rate}}{\text{discount rate} - \text{growth rate}}$$

The basic valuation formula is appropriate when the intellectual property revenue stream is a perpetuity (that is, does not have a finite remaining useful life [RUL]), and the expected annual rate of change in that intellectual property revenue stream (whether positive or negative) is constant. When these two simplifying assumptions are not appropriate, then the valuation analyst will modify the basic valuation formula accordingly. That is, instead of using the basic direct capitalization method formula, the valuation analyst will use a discount projection period yield capitalization method formula.

When using the RFR method (whether a direct capitalization method or a yield capitalization method), the valuation analyst should consider the following procedures:

- Select an intellectual property-specific royalty rate (and not necessarily the mean, median, mode, etc. royalty rate from the guideline intellectual property transactional data).
- Use a normalized or stabilized revenue base for the intellectual property owner/operator (and not necessarily the last year's actual revenue or the next year's projected revenue).
- Use a discount rate that is consistent with
  - the selected standard of value and premise of value.
  - the risk of the subject intellectual property.
  - the income tax level of the projected royalty income.
- Use an expected long-term growth rate that is consistent with
  - the age and RUL of the intellectual property.
  - the cost to maintain the intellectual property.
- Adjust the royalty payment as needed to account for the cost to develop (if still in development) or maintain the intellectual property.
- Use the yield capitalization model for a growth rate royalty payment projection.
- Use a limited life direct capitalization rate for a constant growth rate royalty payment projection, if the intellectual property has a limited RUL.

PRINT SOURCES FOR ROYALTY RATE DATA

The following publications are some of the print data sources for intellectual property license royalty rates that the valuation analyst commonly considers:

1. Battersby, Gregory J. and Charles W. Grimes. *Licensing Royalty Rates*, 2008 edition (New York: Aspen Publishers).
   This is the most recent edition of a data source that is published annually.
2. *Licensing Economics Review* is a bimonthly newsletter that publishes royalty rates of selected I/P license transactions and provides an annual survey in December of average royalty rates by industry. It is published by AUS Consultants (**www.ausinc.com/auscon.html**).

ONLINE SOURCES OF ROYALTY RATE DATA

Valuation analysts often use four common online data sources to search for guideline intellectual property license royalty rates. Summary descriptions of these four online license data sources are as follows.

Financial Valuation Group Intellectual Property Transaction Database

8074 N. 56th Street, Tampa, FL 33617 (813/985-2232), **www.fvgi.com**

The Financial Valuation Group Intellectual Property Transaction database includes many types of intellectual property license transactions, such as product, patent, mineral rights, franchise/distribution rights, copyright, trademark, trade name, technology, software, and proprietary information. The database consists of approximately 40 fields of potentially useful data for each reported intellectual property license transaction. Custom intellectual property royalty rate searches may be designed to find transactions based on standard industrial classification (SIC) codes, North American Industry Classification

codes, keywords, industry, type of transaction, payment structure, or application.

A custom search costs $150; this price is applied toward the purchase of the intellectual property license transaction summaries. Each transaction summary costs $60. Each supporting document costs $30. A $25 shipping and handling fee is charged for the overnight delivery of print copies of the license transactional data.

Exhibit 1 presents an illustrative sample intellectual property license summary from the Financial Valuation Group license transaction database.

RoyaltyStat

5404 Blackstone Road, Bethesda, MD 20816-1821, (301/299-1018), **www.royaltystat.com**

The RoyaltyStat database contains the name of the licensor, licensee, intellectual property description, license royalty rate, exclusivity, duration, and the territory covered by selected intellectual property license agreements. The RoyaltyStat database is useful for finding royalty rates for licensing intangible property, finding industry or guideline royalty rates, determining buy-in payments and purchase price allocations, estimating litigation damages, and valuing intellectual property for mergers, acquisitions, divestitures, or bankruptcies. The user may search the database by SIC code or by full text queries. Summary statistics, including quartiles of selected royalty rates, are available.

The annual subscription database costs $3,500 for a maximum of 150 license agreements. Searches that exceed 150 license agreements are charged $25 for each additional license agreement.

RoyaltySource from AUS Corporation

P.O. Box 1050, Moorestown, NJ 08057-1050 (800/925-4287), **www.royaltysource.com**

The RoyaltySource database identifies the licensee and licensor, provides

Exhibit 1: The Financial Valuation Group
Illustrative Sample Intellectual Property License Transaction Data

Licensor:	Thomas J. Ulrich
Licensor 1987 SIC:	6794
Licensor 1997 NAICS:	533110
Licensor Country:	U.S.
Licensor Industry:	Custom Computer Programming Systems
Type of Agreement:	Patent
Secondary Type:	Product
Patent or Trademark Number:	4,803,719
Geographic Region:	Worldwide
General Industry:	Patent Owner or Lessor
Remuneration Structure:	Flat Fee/Percent
Flat %:	3.00%
Range % Low End:	
Range % High End:	
Percent Based On:	Gross sales price of all licensed products sold or otherwise disposed of.
Base Definition:	
Additional Payment/ Consideration:	In addition, Licensor shall be issued 50,000 shares of common stock in Fonecash, Inc.

Licensee:	FoneCash, Inc.
Licensee 1987 SIC:	7371
Licensee 1997 NAICS:	541511
Licensee Country:	U.S.
Licensee Industry:	Custom Computer Programming Systems
Term of Agreement:	
Term Type:	Patent Life
Month of LA:	11
Day of LA:	1
Year of LA:	1997
Original or Amended:	Original
Exclusive:	
Description of Product or Service:	License to patent method for powering telephone apparatus directly from the telephone line without external power.
Flat Fee:	$30,000.00
Range $ Low End:	
Range $ High End:	
Dollar Royalty Based On:	Flat fee to be paid as such: $5,000 due in 30 days after signing; $25,000 upon first funding of the IPO any other
Guaranteed Annual Royalty:	$10,000 for 1999; $20,000 for 2000
Maximum Fee for Life of Agreement:	
Comments:	
Source Document:	10SB12G - Ex
Date of Source:	12/30/1999

Wednesday, October 03, 2007

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an industry description or code, and describes the intellectual property licensed or sold. It also provides royalty rate details and other intellectual property compensation, such as upfront payments or equity positions; transactions terms, such as exclusivity or geographical restrictions; and source of information. AUS consultants tracked intellectual property royalty rate information for more than 16 years. This database searches patents, technology, and trademark sale and license transactions. The research begins after a discussion of the technology, industry, and key words. Customers can make requests by telephone or online.

The cost for up to 10 transactions is $250. The cost for up to 20 transactions is $300. The charge increases $50 for every additional 10 transactions. If no relevant license/sale transactions are found, then the charge is only $100.

Exhibit 2 presents an illustrative sample intellectual property license summary from the RoyaltySource license transaction database.

Deloitte Recap LLC—rDNA's Biotech Alliance Database
2033 N. Main St., Suite 1050, Walnut Creek, CA 94596-3722 (925/952-3870), **www.rdna.com**

Deloitte Recap (Recap) specializes in biotechnical alliances, earned alliance revenue, product sales, employment agreements, and company information and capitalization. Although this database contains license-related royalty rate data, it is not exclusive to intellectual property. This database tracks and analyzes nearly 15,000 biotechnology company alliances entered into since 1971. The search results indicate whether the subject alliance has filed Security and Exchange Commission (SEC) disclosures and Recap has completed an analysis. The search results also provide links to licensor/licensee press releases and valuation history graphs.

Access to the database is by subscription. The duration and type of subscription determine the cost. In addition to providing access to this database via a subscription, Recap provides deal-specific or consulting services on either a project basis or a retainer basis.

Exhibit 2: RoyaltySource Illustrative Sample Intellectual Property License Transaction

RoyaltySource Intellectual Property Database
-A service provided by AUS Consultants-

Technology License

Licensee:	NONINVASIVE MEDICAL TECHNOLOGIES LLC
Licensee Business:	Electromedical equipment
Licensor:	LIFE SIGNS DETECTION SYSTEMS, INC.
Licensor Business:	Electromedical equipment
Royalty Rate, % (low range):	5.0
Royalty Rate, % (high range):	5.0
Upfront Fee:	$300,000

Licensed Property:
In an exclusive agreement dated March 6, 2006, the Licensee was granted the use of technology that will provide heartbeat and respiration waveform through two layers of normal wear clothing. The Licensor acknowledges that this Agreement provides the Licensee a perpetual License to use the RF technology for vital signs monitoring and further acknowledges that the Licensee shall have exclusive ownership and title to all derivative technologies.

The Licensee has also entered into a contract with the U.S. Military whereby it is developing what is known as the Marco Polo project E-Tag system in connection with its desire to attempt to utilize the vital signs monitoring technology.

Compensation Detail:
Upfront Fee: Initial Payment of Three Hundred Thousand ($300,000) Dollars

Royalty: Life Signs Detection Systems ("LSDS") will receive a royalty of 5% of the actually paid gross sales of any derivative products that incorporate LSDS's RF technology for vital signs monitoring which are based on LSDS's hardware, software, technology, trade secrets and intellectual property conveyed. The royalty will not exceed 50% of the actual net profits on annual commercial sales.

LSDS will also receive a royalty of 5% of the actually paid annual gross sales of the E/Tag device in connection with sales to the military/government, not to exceed 50% of the actual net annual profits.

Source: Form SB-2 NONINVASIVE MEDICAL TECHNOLOGIES INC, 02/13/2007

The source of information provided in this report has been gathered from public financial records, news releases, and other articles and references, and also includes all of the Licensing Economics Review (LER) issues. While we believe the sources to be reliable, this does not guarantee the accuracy or completeness of the information provided.

OTHER SOURCES OF ROYALTY RATE DATA

A valuation analyst can use other sources to research guideline intellectual property license royalty rate data. Approaches to gleaning data from these other sources include the following:

- Research of SEC document disclosures of selected guideline publicly traded companies
- Research of subject industry trade publications/newsletters and subject industry trade associations

- Investigation of the subject owner/operator actual inbound/outbound intellectual property licenses
- Independent confirmation of the subject owner/operator anecdotes regarding industry intellectual property license agreements

The RFR method is based on the capitalization of a hypothetical intellectual property license royalty income/expense projection. The reliability of the royalty projection is based, at least in part, on the reliability of the selected hypothetical license royalty rate. And the reliability of the selected royalty rate is based, at least in part, on the quality of the valuation analyst's research of empirical royalty rate data.

Robert Reilly, CPA/ABV, is firm managing director and resident in the Chicago office of Willamette Management Associates. He is coauthor and coeditor of several professional books and has served as editor and columnist for several professional periodicals. Currently he is an editor for the *ABI Journal*, and he is the intellectual property editor for *Valuation Strategies*. He can be reached at rfreilly@willamette.com and (730) 399-4318. Ashley L. Reilly is a third year law student at the University of California, Davis Law School.

EXPERT TOOLS

A PRACTICAL GUIDE TO AD VALOREM PROPERTY TAX VALUATION

By Marc Andrew Landis

A review of Guide to Property Tax Valuation *by Robert F. Reilly, CPA/ABV, and Robert P. Schweihs*

The *Guide to Property Tax Valuation* is the latest addition to the collection of various valuation textbooks authored by the team of Robert Reilly, CPA/ABV, and Robert Schweihs, managing directors at the business valuation firm of Willamette Management Associates.

The guide will definitely be of interest to both experienced property tax valuation professionals as well as to those less experienced in the complicated arena of valuation for ad valorem property tax purposes. The authors provide a thorough treatment of the subject matter, which makes it easy for professionals to obtain a broad overview of a topic, or to delve into comprehensive detail and explicit examples when a professional needs further detail.

The guide is laid out in an orderly manner that leads the reader from the basic theory to the general methodology, and then to specific topics. Examples are provided where necessary to further illumine the topic of discussion. The chapter titles in each section are descriptive, which allows the reader to easily find the information he or she is looking for. The book is organized into 10 sections (33 chapters in all).

The guide addresses all types of property—real property, personal property, and tangible and intangible property. In addition, the key topics covered include valuation issues pertaining to income, sales comparison, and cost approaches, with a particular focus on the analytical strengths and weaknesses of each approach. The valuation reporting section contains an especially helpful chapter on valuation expert testimony.

Professionals looking for a well-written and practical text that focuses on the issues of ad valorem property tax valuation need look no further. Few books provide any information on this subject, let alone any devoted entirely to valuation for ad valorem property tax purposes. Anyone involved in the process of ad valorem property tax compliance, appeal, or litigation should have this guide in his or her reference library.

This book is published by Willamette Management Associates.

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ARBITRATION DISPUTANTS: SHARE BIDS BEFORE MAKING INVESTMENT DECISIONS

In the first academic study to examine bidding and investment strategies in final-offer arbitration, economists at the University of Arkansas found that it is best for parties in conflict to make bids publicly observable before deciding how much time, effort, and money to invest in building a case. The results provide insight into how final-offer arbitration procedures might be standardized to minimize inefficient

investments and generate moderate bidding behavior.

Final-offer arbitration is a specific type of arbitration in which the parties in conflict are required to submit a final offer, and an arbitrator chooses one of the two offers; there is no splitting the difference. A high profile example is Major League Baseball's use of this type of arbitration in labor disputes between players and owners.

"The breadth of cases settled by arbitration is rapidly expanding," said Cary Deck, associate professor of economics at the Sam M. Walton College of Business. "There are good reasons for this. As an alternative to civil litigation, the benefits of arbitration include quicker resolution and substantial savings in time and money. But there really aren't any standards for how to go about arbitration. This fact, coupled with the increasing reliance on arbitration in practice, necessitates an understanding of the strategies and incentives that the various forms of arbitration may generate."

Deck, together with Amy Farmer, professor of economics at Walton College, conducted theoretical and controlled laboratory experiments on several final-offer arbitration scenarios dealing with the timing of offers and when or if disputants observe each other's offer. As Deck mentioned, the researchers also examined the extent to which the variables of timing and disclosure influenced how much time, money, and effort to invest in a case and what kind of offer to make. Some of their findings clash with popular arbitration strategies. Most notable of these findings is that the sharing of bids early in the process, prior to investment, most likely will lead to a mutually optimal settlement.

"We found that when disputants placed publicly observable bids prior to investing, those bids were less extreme and therefore more moderate, or closer together," Deck said. "In other words, the parties operated with considerable information about the opposition's case. So there may be a spirit of cooperation or accountability to reach a mutually acceptable agreement. One might not be surprised that making strategies public will enhance cooperation."

ARBITRATION SCENARIOS

In theoretical tests, the researchers developed four arbitration scenarios: Invest Public, Bid Public, Bid Private, and Invest Private. In Invest Public, investments (time, money, and effort devoted to building a case) were made and observed by both parties prior to the submission of final offers. Bid Public described a situation in which investments were made after the submission of final offers that were observable by both participants. In Bid Private, investments were made after the submission of final offers that were sealed or otherwise not observable to the parties. Finally, Invest Private was a situation in which bids were made after unobservable investments.

In addition to the main finding that publicly observable bids prior to investing were less extreme, laboratory experiments on three of the four theoretical scenarios produced the following results:

- Investments were lower than predicted in all three cases.
- Bid Private offers were more extreme, or aggressive, than Bid Public offers.
- Settlement rates were nominally highest (60%) in Bid Public and nominally lowest (53%) in Bid Private.

The researchers' study will appear in a forthcoming issue of the *Journal of Economic Behavior and Organization.* Professors Farmer and Deck, along with Dao-Zhi Zeng of Kagawa University and Zhejiang University, have also written an article, "Amended Final-offer Arbitration Outperforms Final-offer Arbitration" for *American Law and Economics Review*" (October 2007).

FASB TO FIX MEASUREMENT AND DISCLOSURE OF FAIR VALUE ESTIMATES

On February 18, 2009, Robert H. Herz, Chairman of the Financial Accounting Standards Board (FASB), announced the addition of new FASB agenda projects intended to improve the application guidance used to determine fair values and disclosure of fair value estimates. The projects respond to recommendations contained in the Securities and Exchange Commission's (SEC) recent study on mark-to-market accounting. The projects also respond to the input provided by FASB's Valuation Resource Group (VRG), a group of valuation and accounting professionals who provide the FASB staff and board with information on implementation issues related to fair value measurements used for financial statement reporting purposes.

According to Chairman Herz, "The SEC expressed continued support of fair value accounting in its study, but recommended consideration of potential improvements in the guidance surrounding the application of fair value principles. We agree with the SEC and with our Valuation Resource Group that more application guidance to determine fair values is needed in current market conditions. Additionally, investors have asked for more information and disclosure about fair value

estimates. Therefore FASB is immediately embarking on projects that directly address areas that constituents have told us are challenging in the current environment, and which will improve disclosures in financial reports."

The fair value projects address both application and disclosure guidance:

- The projects on application guidance will address determining when a market for an asset or a liability is active or inactive; determining when a transaction is distressed; and applying fair value to interests in alternative investments, such as hedge funds and private equity funds.
- The project on improving disclosures about fair value measurements will consider requiring additional disclosures on such matters as sensitivities of measurements to key inputs and transfers of items between the fair value measurement levels.

FASB anticipates completing projects on application guidance by the end of the second quarter of 2009 and the project on improving disclosures in time for year-end financial reporting. FASB has also recently proposed enhanced disclosures in interim reports relating to the fair value of financial instruments. Proposed FASB Staff Position (FSP) FAS 107-b and Accounting Principles Board (APB) 28-a is available at **www.fasb.org/fasb_staff_positions/prop_fsp_fas107-b&apb28-a.pdf**.

FASB has also begun work with the International Accounting Standards Board (IASB) on a more comprehensive project to improve, simplify, and converge the accounting for financial instruments. The boards are obtaining input on that project from several sources, including the senior-level Financial Crisis Advisory Group that has been formed to assist FASB and the IASB in evaluating financial reporting issues emanating from the global financial crisis.

The SEC study, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*, was issued to Congress by the SEC's Office of the Chief Accountant and Division of Corporate Finance on December 30, 2008, as mandated by the Emergency Economic Stabilization Act of 2008. The 211-page report recommended against suspending fair value accounting standards and, instead, recommended making specific improvements to existing practice. The report reaffirms that investors generally believe fair value accounting increases financial reporting transparency and that the information it provides results in better investment decision-making. The report is available at **www.sec.gov/news/studies/2008/marktomarket123008.pdf**.

On February 5, 2009 the FASB VRG met to provide the board with input on fair value issues. The group was formed in June 2007 in response to feedback received from constituents calling for the board to address issues relating to valuation for financial reporting. More information about the VRG and its members is available at **www.fasb.org/project/valuation_resource_group.shtml#background**.

IRS ACKNOWLEDGES DIFFICULTY IN VALUING REAL PROPERTY

By Lance S. Hall, ASA

The following article was published in the February 11, 2009 edition of The FMV Valuation Alert *and is reprinted here with the permission of FMV Opinions, Inc.*

On February 9, 2009 the Director of the IRS Small Business/Self-Employed Division issued "interim guidance on obtaining additional review of real property valuations in offer in compromise cases ...."[1] Importantly, the IRS acknowledged that

> "During these current economic times the value of real property may be difficult to determine in specific markets and is frequently an area of dispute in the computation of reasonable collection potential. The purpose of the additional review is to confirm the value of the real property and ensure that the reasonable collection potential has been properly determined. These procedures are meant to supplement, not replace, the financial analysis and review provisions of the Internal Revenue Manual.
>
> All employees should be sensitive to the current economic conditions that may be affecting taxpayers when investigating the acceptability of an offer. Employees should continue to utilize all available resources to arrive at the most accurate property valuation possible, including a discussion with the taxpayer or their representative, or both, on the methods used to value the taxpayer's property."

Although this statement is not directly tied to estate and gift tax valuations and valuations of ongoing businesses, it is encouraging to note

1 SBSE-05-0209-006

that the IRS, as a result of these difficult times, appears willing to consider the negative impact of these troubled times on valuations. This is just another indication that now may be the time to gift.[2]

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2 Other reasons include (a) higher market volatility has resulted in substantially higher discounts for lack of marketability, (b) AFR rates are at historical lows, (c) asset values are considerably lower than they were just six months ago, and (d) the threat (although apparently low) of the elimination of valuation discounts (see H.R. 436).

Letters to the Editor

CPA Expert encourages readers to write letters on issues related to valuation, forensic, and litigation services and on published articles. Please include your name and email address. Send your letters by e-mail to wmoran@aicpa.org.

BV NETWORKING GROUPS

The AICPA Forensic and Valuation Services (FVS) membership section is taking early registration for the inaugural BV Networking Group. The group is designed to allow valuation firm managers and executives to meet in a confidential environment for the purpose of sharing and discussing best practices and lessons learned. This is a unique opportunity to enhance your business valuation practice. The group meeting will be held on June 4–5, 2009 at the AICPA's main office in New York, NY. The keynote speakers are Jay Fishman, Managing Director of Financial Research Associates, and Kevin Yeanoplos, CPA/ABV/CFF, ASA, Director of Valuation Services for Brueggeman and Johnson Yeanoplos, P.C. The registration fee is $400. To find out more information, please visit www.aicpa.org/bvnetwork or email us at bvnetwork@aicpa.org.

FOCUS IS GOING GREEN!

Beginning with the January/February 2009 Issue, *Focus*, the newsletter distributed gratis as a benefit to FVS Section members, will no longer be printed and mailed to members. Instead, members will be alerted by email when each issue is posted to the FVS Web site and will be provided a link to each issue.

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